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January 27, 1999

Magalie Roman Salas, Secretary
Federal Communications Commission
445 Twelfth Street, SW Room TWB-204
Washington, D.C. 20554

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JAN 27 1999

RE: Notice of Ex Parte meeting: In the matter of Access Charge Reform, CC Docket No. 96-262; Price Cap Performance Review for LECs, CC Docket No. 94-1; MCI Telecommunication Corp. Emergency Petition for Prescription, CC Docket No. 97-250; and Consumer Federation of America Petition for Rulemaking, RM-9210

On Tuesday January 26, 1999 Paul Malandrakis of AT&T, and I met with Jay Atkinson, Chris Barnekov, and Steve Spaeth, from the Competitive Pricing Division of the Common Carrier Bureau, and Anthony Bush, Chief Economist of the Office of the General Counsel, concerning matters related to the referenced proceedings. We discussed the arguments reflected in AT&T's filings in these proceedings concerning access reform and LEC pricing flexibility. The attachments were referred to during the discussion.

Two copies of this Notice are being submitted to the Secretary of the FCC in accordance with Section 1.1206(a)(1) of the Commission's rules.

Sincerely,

Brian W. Masterson

Attachment

cc: Jay Atkinson
Anthony Bush
Chris Barnekov
Steve Spaeth

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Access Reform

- **The FCC's assumptions underlying its market-based approach are invalid and should be revisited.**
- **Competition robust enough to drive down access rates has not developed anywhere in the nation, and the LECs continue to price at the upper limit in every basket.**
- **Mechanisms should be adopted to reduce access charges to cost as soon as possible.**

Access Reform

- **The FCC should accelerate the timetable on the prescriptive backstop to the market-based approach.**
- **Access rates should be set at economic cost.**
- **In its price cap review, the FCC should increase the X-Factor to reflect interstate only productivity data, rather than total company data.**

Contribution from Interstate Switched Access -- Non-Rural Only

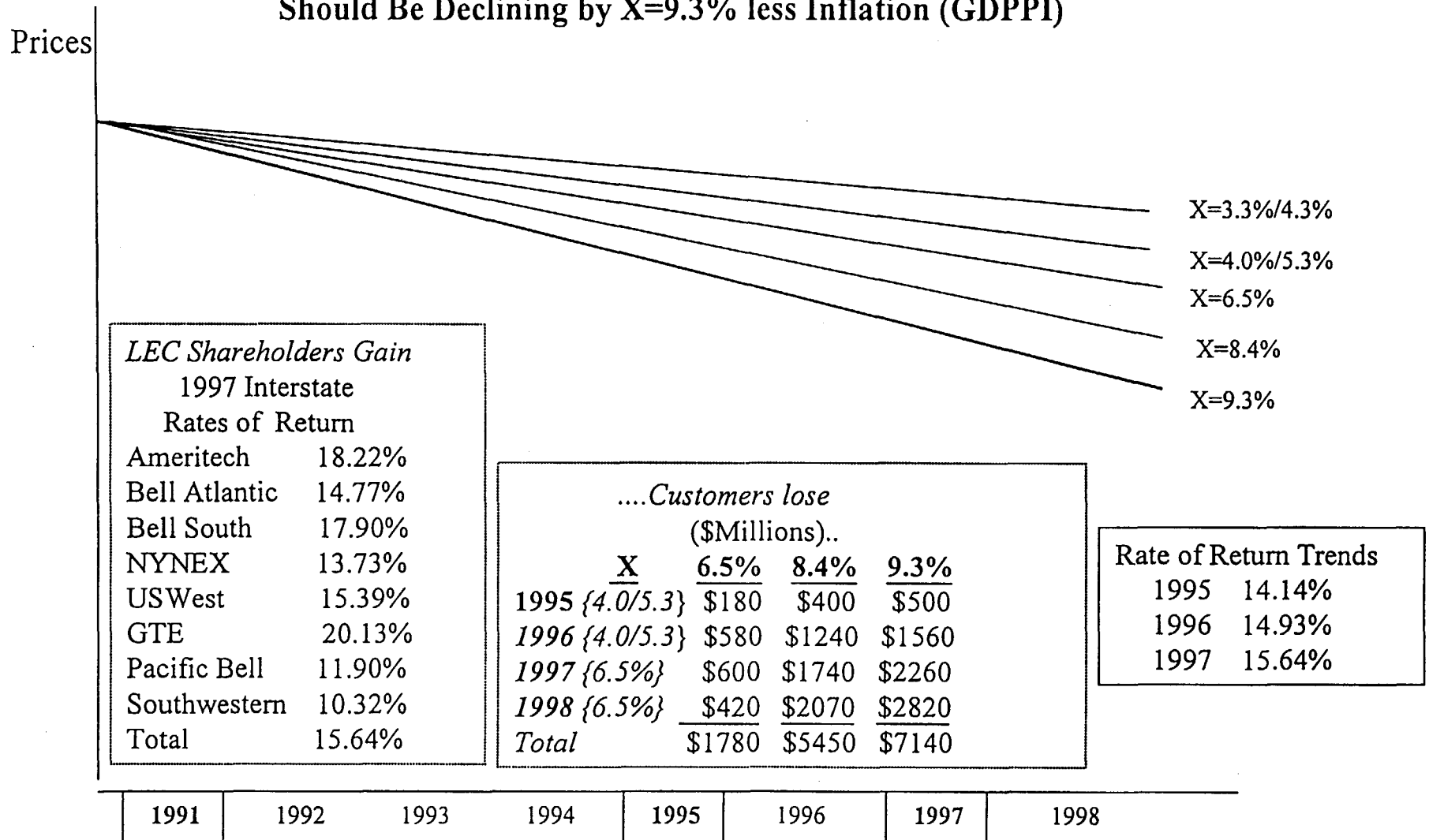
Company	1998 Total	Per Switched Access MOU		Contribution from Access	
	Estimated Switched Access MOU	Economic Cost*	ILEC Rates**	Per Access MOU***	Annualized Total***
	(Millions)	(Blended HAI)	(as of 7/1/98)		(\$ Millions)
Ameritech	54,348	0.00224	0.0167	0.0145	786
Bell Atlantic	74,686	0.00257	0.0142	0.0116	869
NYNEX	58,884	0.00209	0.0249	0.0228	1,343
Bell South	80,671	0.00238	0.0199	0.0175	1,413
PacTel	42,652	0.00235	0.0146	0.0123	522
SBC	45,684	0.00265	0.0168	0.0142	646
USWest	60,089	0.00286	0.0220	0.0191	1,150
Sub-Total RBOCs	417,014	0.00245	0.0186	0.0161	6,730
GTE	52,855	0.00546	0.0293	0.0238	1,260
SPRINT	22,707	0.00517	0.0240	0.0188	428
Cincinnati	3,128	0.00413	0.0161	0.0120	37
Lincoln	727	0.00939	0.0228	0.0134	10
Rochester	2,521	0.00507	0.0235	0.0184	46
SNET	8,814	0.00284	0.0194	0.0166	146
Other Non-Rural	2,752	0.00718	0.0282	0.0210	58
Total Non-Rural	510,518	0.00295	0.0200	0.0171	8,715
Less USF Flowback					852
Total Non-Rural Contribution -- adjusted for USF Flowback					7,863
<i>Notes: * HAI Default Scenario (Blended -- 80% Dedicated and 20% Tandem) -- Version 5.0a</i> <i>** ILEC Switched Access Rates includes PICC, which is approximately 18% of the cost</i> <i>*** Includes share of USF FLOWBACK of \$852 millions which is on an average 9.78% of the contribution.</i>					

Price Cap Regulation-- AT&T's Petition for Reconsideration

- *AT&T requested the Commission to reconsider the following matters:*
 - » Erroneous reliance on “total company” data, rather than interstate only data.
 - » Interstate productivity growth is 1.9-2.8 percentage points greater than total company growth.
 - » Improper retention of the low-end adjustment mechanism in the price cap system.
 - » Failure to apply the revised X-Factor to LEC PCIs for the 1995 tariff year.

Prices for Interstate Access Charges

Should Be Declining by X=9.3% less Inflation (GDPPI)



Note: Illustrative, not drawn to scale

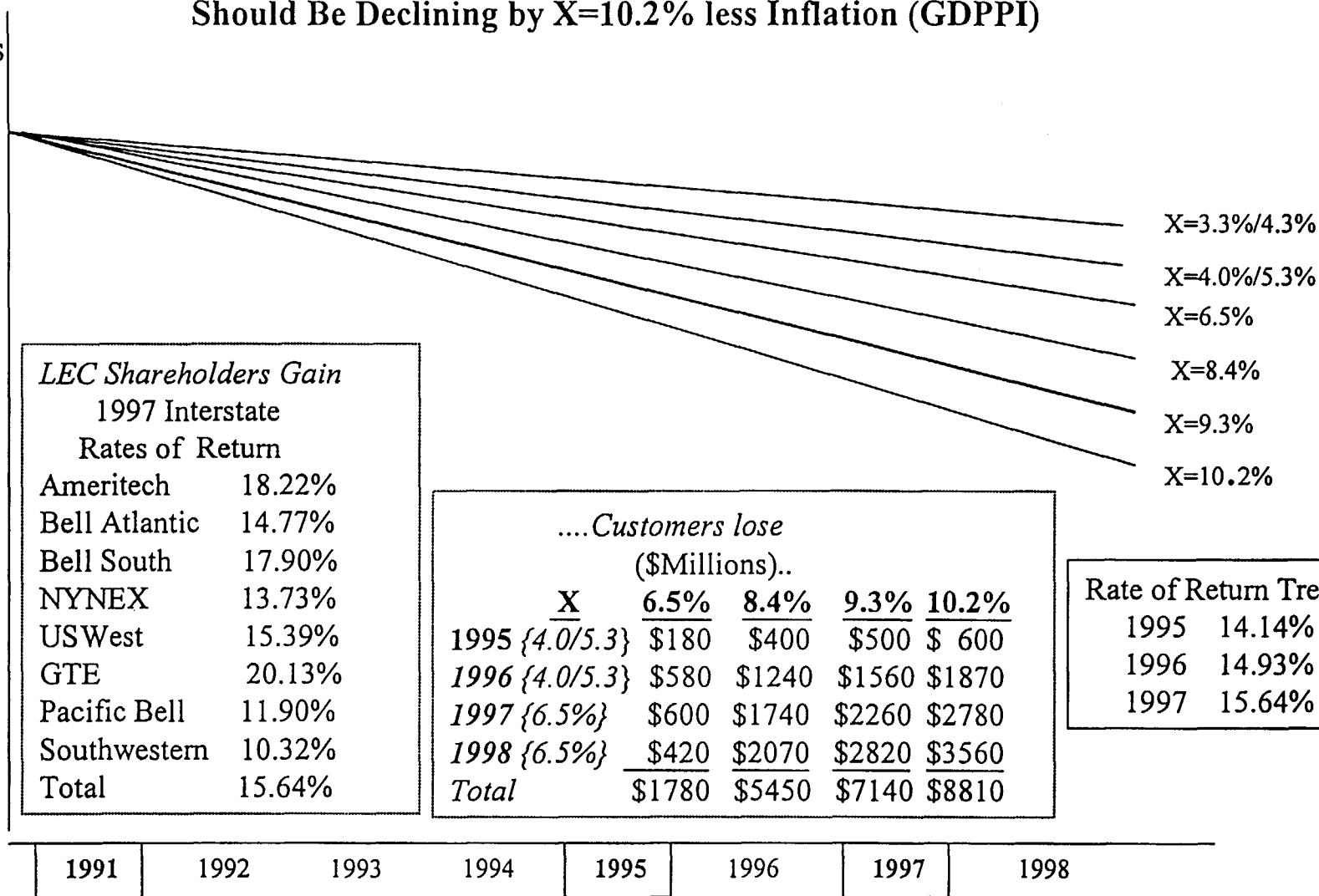
***Price Cap Regulation--
Reinitialization of Interstate X-Factors***

Reinitialize to:	Current X=6.50%	Reinitialize to 8.40%	Reinitialize to 9.30%	Reinitialize to 10.20%
1998	N/A	(\$442)	(\$651)	(\$860)
1997	N/A	(\$886)	(\$1298)	(\$1765)
1996	N/A	(\$1320)	(\$1947)	(\$2565)
1995	(\$370)	(\$2029)	(\$2952)	(\$3781)

Prices for Interstate Access Charges

Should Be Declining by $X=10.2\%$ less Inflation (GDPPI)

Prices



Note: Illustrative, not drawn to scale

Price Cap Regulation -- The X-Factor

- **The X-Factor should be increased to reflect the higher productivity growth of Interstate Access Services**
 - » **There is no credible evidence that the X-Factor has declined in recent years, as the LECs contended**
 - » **On the surface, USTA's update of the FCC's total company productivity study appears to show a declining X-Factor**
 - » **These Results, however, cannot be blindly accepted at face value without examining the components of the X-Factor and understanding the underlying factors at work**

- **USTA's argument that productivity growth is slowing down is based on:**
 - » **Soaring LEC earnings that cause the input price index to rise in the FCC model.**
 - » **Failure to reflect the substantial growth in usage that has occurred in the last 2-3 years.**

- **The recent surge in LEC earnings has the unintended consequence of causing the measured X-Factor to decline in the updated FCC model**
 - » **USTA cites an X-Factor of 2.11% for 1996, followed by a 4.14% in 1997, as evidence that recent productivity growth is declining**
 - » **For 1996, closer examination of the data shows that the low X-factor is attributable in part to an unusually large increase (9.07%) in the “Capital Rental Price Index.” (1)**

(1). The capital rental price is calculated as the ratio of “property income with depreciation” to the computed capital stock. Property income is equal to total revenue less expenses.

- » This inflates the input price index and reduces the X-Factor. A 9.07% increase in the capital rental price causes the input price index to rise by 3.8% and reduces the computed X-Factor for 1996 by 3.8%. ⁽²⁾
- » The increased “capital rental price” is due to a huge surge in LEC earnings from 1995 to 1996 rather than any increase in the real cost of LEC inputs. The RBOCs’ total composite (state and interstate) ROR rose from 10.87% in 1995 to 12.46% and 13.56% in 1996 and 1997. ⁽³⁾
- » In the FCC model, increased earnings are treated as an increase in the price of LEC inputs and serve to reduce X-factor. USTA’s analysis perversely interprets soaring LEC earnings as an indication that the X-Factor is declining.

(2) 3.8% is derived by multiplying 9.07% times the 42.3% capital share of total factor payments.

(3) Much of the increase in RBOC earnings occurred at the state level, with total intrastate earnings increasing from \$6.9B in 1995 to \$9.1B in 1997. Interstate earnings increased from \$3.5B to \$3.8B during the same period (ARMIS 43-01).

- **Reflecting the substantial growth in usage that has occurred in the last 2-3 years shows that the X-factor is increasing**
 - » **Use of publicly available data (i.e. , 1996 intrastate DEMs, 1997 special access lines) increases Gollop's X-factors from 2.1% to 2.5% in 1996 and from 4.1% to 4.6% in 1997. (4)**
 - » **Use of local DEMs instead of local calls increases the X-factor to 5.2% for 1996 and to 9.7% for 1997.**

(4) Based on revised data from the 12/98 Statistics of Communications Common Carriers

- **Reflecting the substantial growth in usage that has occurred in the last 2-3 years and adjusting for the capital rental price**
 - » **Results in total company X-factors of 9.4% in 1996 and 12.2% in 1997. ⁽⁵⁾**

⁽⁵⁾
*Adjusted for distortion caused by soaring LEC earnings
(LEC revenues are adjusted to produce 10.57% overall ROR in 1996/97)*

Price Cap Regulation -- The X-Factor

- **The X-factor should be based on the higher productivity growth of interstate access services.**
 - » **Growth in interstate output far exceeds growth in total company output.**
 - » **Growth in interstate costs has not exceeded growth in total company costs.**

- **The X-factor should be based on the higher productivity growth of interstate access services.
(contd.)**

- » **The continuous rise in LEC interstate RORs -- from 11.78% in 1991 to 15.64% in 1997 -- confirms that interstate productivity growth has far exceeded the X-factors in effect.**
- » **LECs have repeatedly argued in state proceedings that intrastate productivity growth is less than interstate . Current intrastate X-factors are lower as a result.**
- » **The FCC should thus focus on interstate results in developing the X-factor.**

- **Contrary to LEC arguments, rising interstate rates of return are relevant to the X-factor issue**
 - » **The FCC's objective is to "ensure that ongoing gains by the LECs in reducing unit costs are passed through to consumers" [FCC's Fourth FNRPM in Docket 94-1 (9/27/95), para. 16]**
 - » **Increasing interstate RORs indicate that revenues are increasing by more than (regulated) costs, and prices are thus increasing relative to unit costs. Reductions in unit costs are not being passed through to consumers.**

- **The linkage between earnings and the X-factor is recognized by the LECs' own consultants:**

“The annual price cap adjustment formula is designed so that if the firm exceeds industry average productivity growth (its productivity target), its earnings will increase, and if it falls short of industry average productivity growth, its earnings will decline.” (7)

(7) Taylor, Tardiff and Zarkadas, “Economic Evaluation of Selected Issues from the Fourth Further Notice of Proposed RuleMaking in the LEC Price Cap Performance Review,” attached to USTA Reply Comments in Docket 94-1 (3/1/96).

- **If the X were set properly, firms that exceed industry average productivity growth would enjoy rising earnings, while firms that fall short would have declining earnings.**
- **If most firms enjoy increasing earnings ratios, this is strong evidence that the X-factor is too low.**
- **The rising trend in LEC interstate rates of return corroborates AT&T's estimates of interstate productivity growth.**

Price Cap Regulation -- The X-Factor

- Recalculation of the X-factor in the FCC model to reflect growth in interstate output, adjustments for separations, adjustments for the capital rental price index, and adjustments for access reform results in an X-factor of 10.2% for the period 1987-1997.**
- Adding the CPD yields 10.7%**

Adjustment To The USTA Study

Estimated X-Factors

	1996	1997	1987-97	1987-97
Total Company Estimates	Without CPD			With CPD
Gollop Study (USTA filing)	2.1%	4.1%	5.4%	5.9%
Use published data*	2.5%	4.6%	5.5%	6.0%
Use local DEMs**	5.2%	9.7%	6.2%	6.7%
Adjust for LEC earnings***	9.4%	12.2%	6.8%	7.3%
Adjust for access reform****	9.2%	12.2%	6.6%	7.1%
Interstate-only Estimates				
Use interstate output	6.6%	10.2%	10.0%	10.5%
Adjust for separations	8.0%	10.0%	10.4%	10.9%
Adjust for LEC earnings	12.0%	12.6%	11.0%	11.5%
Adjust for access reform****	11.5%	12.4%	10.2%	10.7%

*Reflects updated data for 1997 from the December 1997 Statistics of Communications Common Carriers

**Use of local DEMs to calculate growth in local service output from 1995 to 1997.

***Adjusted for distortion caused by soaring LEC earnings (LEC revenues are adjusted to produce 10.57% overall ROR in 1996/97)

**** Based on Gollop's estimated impact of access reform on output growth and the X-factor.